



A Plan for Fiscal Reform
in
South Carolina
State Government

by
State Treasurer Converse Chellis
January 2009

Having served in the General Assembly for eleven years and having also served as State Treasurer for the past year and a half, I feel it is incumbent upon me to offer some ideas for fiscal reform. We are in an unprecedented economic period in the history of both our state and country, one unlike any in recent times. I mention both state and country because their economies are as intertwined as kudzu along a Southern hillside. As the national economy has eroded, the repercussions have been felt in all fifty states. As in other states, here in South Carolina, we face an environment plagued with uncertainties.

We can sit back and talk about the problems that exist, and point at who's to blame. We can watch well intentioned leaders refuse to cooperate because of political pride or a desire for career advancement. Or, we can put politics aside and begin to work together to discuss ways to address our problems and find real solutions.

We owe it to the hard-working families all across South Carolina.

To the teachers, who are educating our next generation and may have to take less salary and less funding; to the small business owners, who are the engine that drives the economic train and are fighting just to stay afloat; to parents, who are working several jobs just to pay the mortgage; to the students, who just want a better education; to senior citizens, who want to live their retirement years without the worry of how they will pay for medication. At the very least we owe them all our commitment to work together, and more so, our pledge to do everything in our power to strengthen our state's economy as soon as possible.

I believe state officials must answer the following questions. How can we strengthen the fiscal foundation of our state? How can we modernize the State's tax and revenue systems to reflect changes in our economy? How can we adequately prepare for future economic downturns? How can we build public confidence in our elected officials and our government operations?

I have outlined several areas, I believe, that warrant attention. I have included the rationale for why they are needed and steps necessary to implement them.

- A. Reform revenue and appropriation policies.
- B. Implement additional steps to stabilize and protect the financial health of the Retirement System.
- C. Adopt initiatives that improve the state's economy by promoting economic development and job creation.
- D. Study ways to improve government effectiveness and efficiency.

Highlights from the four areas include:

- Establish a Revenue Stabilization Fund
- Develop a formal longer-term budget planning model
- Implement zero-based and activity based budgeting
- Promote greater spending transparency
- Require fiscal impact analysis for all legislation
- Eliminate the Competitive Grants Program
- Promote greater tax equity
- Eliminate TERI Program
- Reinstate 30-year retirement for new state employees
- Shorten legislative session
- Create Department of Administration under Governor
- Appoint, rather than elect, some Constitutional Offices
- Create incentives to attract targeted industry
- Establish tourism as a funding priority

A Plan for Fiscal Reform

A. Reform revenue and appropriation policies to promote financial stability

Rationale

South Carolina has long been regarded as a fiscally conservative state, and this reputation has served as the underpinning for its consistently high credit ratings. Following the 2001 recession, however, there was severe budgetary distress that caused the state to take remedial actions that were not typical of a fiscally conservative state in the highest rated states as noted by the credit rating agencies. At that time, the services emphasized the state's need to take additional steps that would promote longer term fiscal stability with a view toward recognizing and planning for future financial challenges. In 2005, the General Assembly enacted legislation that provided for a process of forecasting revenues and expenditures over a three-year time horizon. However, evidence of integration of that process into budgetary planning is not clear. This is extremely important for a number of reasons, but particularly because two components of the state budget – education and healthcare – comprise roughly 75% of the state's general fund expenditures, and the rate of growth of expenditures in these areas is consistently outpacing general fund revenue growth. This trend is particularly acute in fiscal years where revenues do not materialize as forecasted.

The State has two constitutionally established reserve funds totaling 5% of general fund revenues that may be used to address budgetary shortfalls. However, following the 2001 recession, those reserves were depleted and were inadequate in addressing the revenue shortfalls that materialized during those years. Moreover, these funds will not adequately address the revenue shortfalls in the current fiscal year. Accordingly, the state must take steps to address the adequacy of the reserve funds and create a constitutionally established revenue stabilization fund to support orderly response to periods of economic stress.

Despite the fact that replenishment of the funds was among the highest priorities in years whenever revenues recovered, budgetary priorities also focused on restoring funding to programs that had suffered severe cuts during the years of budgetary distress, leaving little of the surplus revenues available to offset revenue shortfalls in future fiscal years. While the General Assembly provided for a statutorily established Contingency Reserve Fund, the opportunity to appropriate those revenues in their entirety in subsequent fiscal years resulted in depletion of those funds so reserved, and as a result, provided little value in addressing the most recent period of revenue volatility. Accordingly, it is essential that the state build on the concept of the Contingency Reserve by establishing a revenue stabilization fund that will retain surplus revenues indefinitely unless they are needed for revenue shortfalls or disaster-related emergencies.

The state should also implement changes in the budgetary process to recognize changes in priority of funding for programs over time, promote informed decisions and transparency, minimize reliance on non-recurring revenue sources, and maintain a statewide focus. The state should also work toward refining the capital planning process to incorporate a longer-term view, and an execution process that promotes efficiency in implementation.

A comprehensive study into the state's revenue components and tax structure needs to be finalized to promote a diversified revenue stream that provides a greater degree of insulation from changes in circumstances throughout economic cycles, thereby promoting the state's ability to maintain structural balance in challenging times.

Implementation steps

1. Evaluate spending limitations¹
2. Determine adequacy of existing reserve funds and establish revenue stabilization fund²
3. Refine the budget process, with a view toward longer term planning³
 - a. Develop a formal longer-term planning model
 - b. Develop a system of scoring and prioritizing program funding, incorporating studies of zero-based and activity-based budgeting
 - c. Promote spending transparency
 - d. Implement a requirement for estimates of fiscal impact for all proposed legislation, to include development of standards of specificity, uniformity, justification and longer-term impact, with integration into the longer-term budgetary planning model
 - e. Develop policies to minimize annualizations, open-ended appropriations, unfunded mandates, and agency deficits
 - f. Eliminate competitive grants or similar programs that tend to earmark funds for programs that will not produce statewide results
 - g. Develop a system for periodic program review and enact sunset provisions

- h. Streamline and improve the capital planning process, with capital projects treated as budget items and integrated into the longer-term budgetary planning model
- 4. Undertake a comprehensive tax review with a view toward reforming and restructuring the tax base in ways that will stabilize and diversify the state's revenue stream
 - a. Evaluate tax burden on individuals and businesses to promote tax equity and minimizing the effects of taxation on economic development and growth
 - b. Coordinate and exploit diversification opportunities between the individual income, sales, property, and corporate tax structures encompassing both state and local government funding

Legislation pending

S.0001: McConnell, Peeler, Leatherman: Spending Limitations; S.0002: McConnell, Peeler, Leatherman: Spending Limitations; S.0011: Peeler, Cromer, et al: Transparency – Roll Call Votes; S.0012: Leatherman, Alexander et al: Taxation Realignment Commission; S.0100: Grooms, Campsen: Transportation Maintenance Fund; S.0130: Sheheen, Campsen: Budget Programmatic Format; S.0171: Cleary: Local Economic Stimulus Grants; H.3010: Cobb-Hunter: State Tax Credit; H.3011: Kirsh: Tax Exemptions; H.3014: MA Pitts: Cigarette Tax; H.3016: Toole: Fees; H.3017: Toole: Tax Increases; H.3037: GR Smith, Harrell, et al: Spending Limitations; H.3047: Haley, Ballentine, et al: Transparency – Roll Call Votes; H.3119: Hosey: Cigarette Tax

B. Implement additional steps to stabilize and protect the financial health of the retirement system

Rationale

Over the last several years, the state has enhanced the financial foundation of the retirement systems by modernizing investment alternatives and addressing future expenses. During 2008, the State Treasurer's COLA Task force made recommendations and the General Assembly enacted legislation to address unfunded liabilities in the systems by establishing financial thresholds that must be achieved before granting additional retirement benefits through cost of living adjustments.

While these were major steps in promoting future financial stability, the state should explore whether or not further results might be achieved by adjusting benefits for future state employees.

Implementation steps

1. Eliminate TERI program
2. Adopt new age and service criteria for retirement eligibility

Legislation pending

H.3009: Kirsh: Close TERI; H.3015: AD Young: SCRS Definition-Employee

C. Adopt initiatives that improve the state's economy by promoting economic development and job creation

Rationale

The state's workforce is gradually undergoing a transition from an agricultural and manufacturing economy to one that is more diversified and knowledge-based. The General Assembly has demonstrated and underscored its commitment to this transition by enacting legislation that supports public education, provides advanced training through the technical education system, and funds the state's universities with financial resources through the Endowed Chairs Program and research university infrastructure funds.

However, the state's economy remains inordinately sensitive to economic downturns and to that end, has been a focal point of concern for fiscal conservatives and the credit rating agencies. Accordingly, the state needs to incorporate funding and processes that will accelerate the transition to a more diversified economy, particularly targeting areas that will increase per capita income.

Implementation steps

1. Develop programs that educate the workforce for growth in targeted industries
 - a. Retraining programs for employees in redirected industries
2. Study ways to attract targeted industries and employers
 - a. Incentives
 - b. Venture capital initiatives
3. Elevate financial commitment to Centers of Economic Excellence as a funding priority
 - a. Endowed chairs
 - b. Research universities
4. Exploit tourism opportunities and natural resources
 - a. Establish tourism promotion as a funding priority
 - b. Conservation
 - c. Study effects of waste industries on natural resources, quality of life, and future economic prospects

D. Study ways to improve government effectiveness and efficiency

Rationale

The state may gain some efficiency by consolidating certain governmental functions into emphasis areas and, where appropriate, integrating their oversight into the cabinet structure. Moreover, the constituency may be better served by a shortened legislative session that will at a minimum promote per diem savings, but may also force a more efficient legislative process that due to time restrictions must target and focus only on the state's most pressing legislative priorities.

Implementation steps

1. Shorten the legislative session
2. Consider establishment of Department of Administration as a cabinet agency
 - a. Determine composition of DOA – agencies and functions to be included
3. Consider appointments of certain constitutional offices

Legislation pending

S.0128: Sheheen, Campsen: Department of Administration; S.0129: Sheheen, Campsen: Constitutional Officers; S.0158: Campsen: Constitutional Officers; S.0159: Campsen: Chief Information Officer; S.0160: Campsen: Constitutional Officers; S.0161: Campsen: Constitutional Officers; S.0162: Campsen: Joint Election of Gov, Lt. Gov; S.0163: Campsen: Constitutional Officers; S.0164: Campsen: Constitutional Officers; S.0165: Campsen: Constitutional Officers

Endnotes

¹ Article X, Section 7 of the State Constitution requires the General Assembly to provide by law for a budget process to insure that annual expenditures of state government may not exceed annual state revenues, and further requires the General Assembly to prescribe a spending limitation on appropriations for the operation of state government which shall provide that annual increases in such appropriations may not exceed the average growth rate of the economy of the State. The limitation may be suspended for any one fiscal year by a special vote. In every fifth annual regular session after 1990, the General Assembly is required to conduct and complete a review of the law implementing the spending limitations. The limit may be exceeded for one year by a two-thirds vote of the Legislature if it first declares a financial emergency. Chapter 11 of Title 11 of the SC Code implements this constitutional mandate, and limits increases in state spending over the previous year to greater of the average percentage increase in total state personal income for the previous three years or nine and one-half percent of total state personal income for the calendar year ending before the fiscal year. At least 30 states have enacted laws designed to limit spending, with various levels of restriction and measurement. While South Carolina's limits are based on personal income, other states base limits on prior year revenues or population/inflation formulas. South Carolina's current restrictions have not sufficiently limited spending growth in a way that promotes fiscal stability over the long term.

² The 2001 recession officially began in March, 2001 and ended in November, 2001, but the state continued to suffer its effects through fiscal year ending 2004, and revenues did not return to their pre-recessionary levels until fiscal year ending 2005. During the fiscal years ending 2001-2004, the state was forced to reduce appropriations by more than \$1.2 billion through mid-year reductions, and roughly \$238 million was withdrawn from the general reserve fund to cover shortfalls that occurred on top of those reductions. While reductions ranged from 4% to 11% on a fiscal year basis, total adjustments were 7.3% of total revenue realized during the period and 29.8% of pre-recessionary (FY2000) annual revenue. The present recession officially began in December, 2007. Since that time, the state has used both the 2007 and 2008 capital reserve funds (totaling \$257.7 million), and \$91.7 million of the general reserve fund to offset budgetary deficits. Further reductions in forecasted revenues for fiscal year ending 2009 have resulted in the legislature reducing appropriations by \$487.9 million and the State Budget and Control board imposing additional reductions of \$383.8 million to address forecasted shortfalls. These reductions result in total adjustments of 9.6% of total revenue realized or forecasted during the 2008-2009 period and 20.0% of pre-recessionary (FY2007) annual revenue.

³ Implementation of a full “zero-based” approach to budgeting would cause a comprehensive process of justification of programs and expenditures, rather than agencies justifying only increases over the previous annual budget without attendant questioning of the previous level of expenditure. To ease transition, a zero-based budget approach could be implemented over a period of fiscal years, with largest programs targeted first, and periodic (e.g. every three years) rather than annual review, if necessary. Implementation of an “activity-based” approach to budgeting would cause a process of review for programs tied to strategic goals, which would provide opportunities to study programmatic objectives, justifications and redundancies. Advantages of these techniques include active prioritization of programs, resource allocations and utilization. They could also promote better accountability, longer-term planning, improvement in overall operations, and identification of obsolete operations and alternative delivery.

Analyses of fiscal impact are provided by the Board of Economic Advisors and the Office of State Budget for proposed legislation to guide the General Assembly in determining potential financial impact of that legislation on general, federal or other funds, and where appropriate, impact on local government. These analyses are integral to promoting not only an informed legislative process, but also impact in future fiscal years. They should therefore become a part of the longer-term budgetary planning model.

The capital planning process is guided by state statute, and generally includes any major non-recurring capital expenditure for an item with an expected useful life of greater than 10 years, including construction, purchase, or major renovation of buildings, streets, or other physical structures and land purchases. A Comprehensive Permanent Improvement Plan (CPIP) is developed by the Capital Budgeting Section of the State Budget and Control Board. The Joint Bond Review Committee reviews and approves capital projects of state agencies and institutions.

Process enhancements include requiring agencies and institutions to disclose the fiscal impact of capital projects on state funds, tuition and fees, setting fiscal limits at start of project, establishing a tracking system for keeping projects on schedule and within budget, establishing uniform standards in planning stages to promote efficiency and avoid inflationary costs caused by delays, providing agencies with specific guidelines for development of A&E projects, defining outcomes for capital investments and linking them to not just the goals of the particular agency or institution, but to the State’s goals, and developing a system for rating maintenance projects.